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Drug Stock Prognosis

By Ralph Weil

There has been considerable negative discussion about the pharmaceutical industry over the last twelve months. This is being generated mostly in the political arena, because a majority of the electorate currently view the industry as needing some sort of reform. Unfortunately, the stock prices of these companies will be subject to this political uncertainty for the remainder of this election cycle.

Good Intentions?

A number of issues have been raised in the ongoing debate, but most of them revolve around the subject of prices charged for prescription drugs here in the United States and the profitability of U.S. drug manufacturers. While the intent of these concerns—beyond getting elected—may be noble, the suggested remedies run counter to economic reality. History is replete with examples of governmental good intentions fostering unintended negative consequences.

Are Drug Prices Too High?

One of the main points raised by the critics is the fact that many drugs are available in other countries at significantly lower prices than in the U.S. They fail to point out two important facts:

1. Governments in some parts of the world control their country's pharmaceutical prices. They do this either by setting the prices for all purchasers or by being the sole purchaser and dictating the maximum they will pay. This means that the high costs of research and development must be recovered mainly in the U.S. drug market.

2. The process of obtaining approval for a new drug is significantly shorter in most other countries than in the U.S. That being the case, the companies want to make sure that their new drugs get marketing rights as soon as possible to help prove both the efficacy and safety in a large patient base. They are therefore willing to accept price restrictions in these countries in order to get their products in use.

Are Profits Too High?

The other main criticism is that pharmaceutical companies tend to be too profitable. Obviously this is a debatable point. How does one define what is too profitable? It is true that the pharmaceutical industry is more profitable than industries

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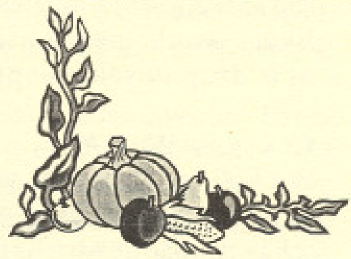

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overall. At the company level, however, profitability varies. Profits go to those companies that have the best new drug profiles. Those companies have the best new product stream because they have spent a great deal of money (hundreds of millions of dollars, in most cases) developing each new drug, some of which may never be successful. Without the incentive of possibly earning large profits on their investments, they most likely would not continue the current pace of new drug development.

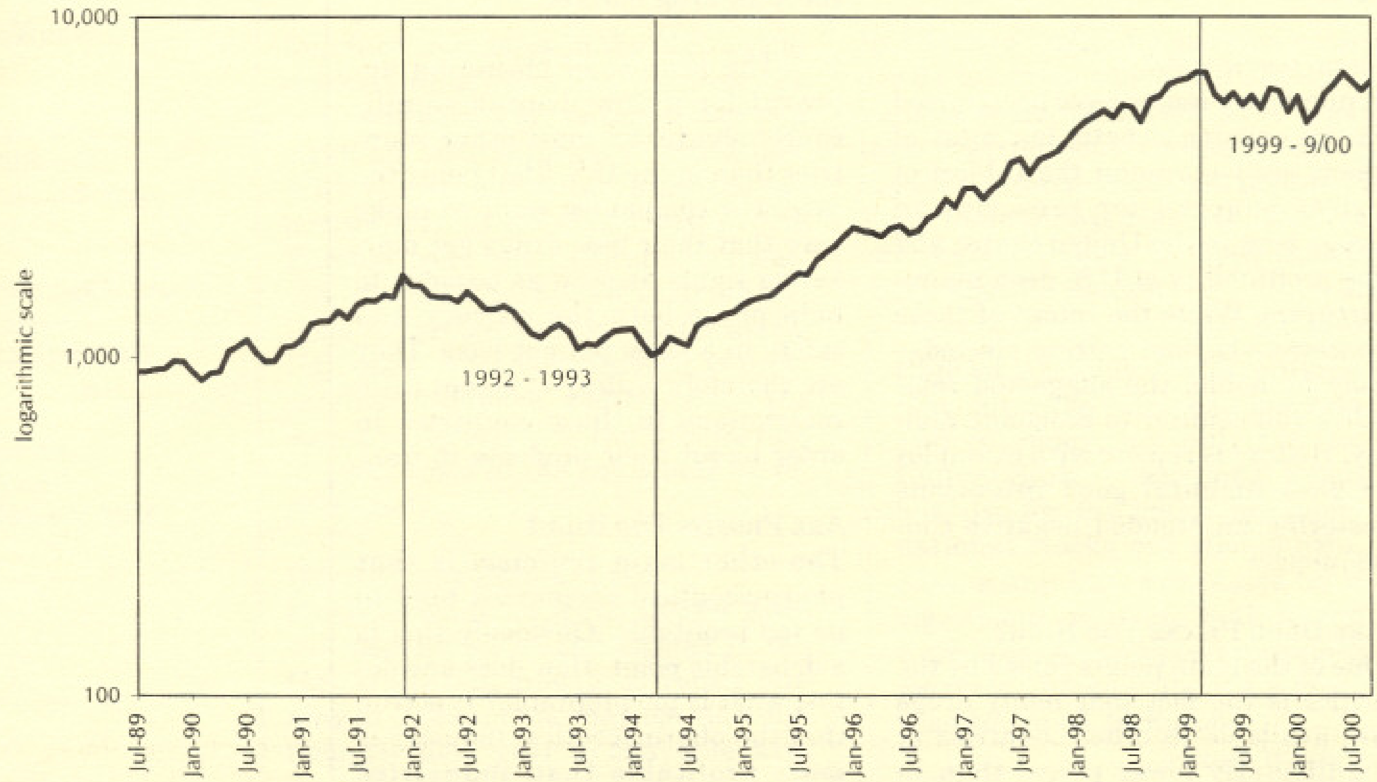
Congress Will Act

We believe Congress will soon pass a bill legalizing the importation of prescription drugs from other countries at what would, early on, be much lower prices than those same drugs sell for here in the U.S. The importation would primarily come from Canada and Mexico, where prices are controlled by the governments. Once the drugs enter the U.S., however, there would be no guarantee that the savings would be passed on to the consumer. Also, the governments of the exporting countries might figure out a way to capture some of the price difference in the form of taxes.

We Are Optimistic

Overall, we expect some short-term volatility in the prices of healthcare-related stocks because of the current political environment, which should ease after election day. When the air clears, investors will realize that the probability of any further adverse legislation passing both houses of Congress anytime soon is remote. We are reminded of the politically charged environment during 1992 - 1993. After considerable debate—and corresponding drug stock price pressure—the public became leery of proposed changes in our healthcare system and the government abandoned its attempt at controlling it. Subsequently, the industry's stock prices recovered dramatically. We believe that those companies with strong cash flows and strong new product streams will return to superior investment performance.

Standard & Poor's Drug Sector Index



We do *not* expect a repeat of the 1992 - 1993 price pattern for drug company stocks.

Some Thoughts on the Euro

By Sharon Bentley-Hamlyn

Our guest author, Sharon Bentley-Hamlyn, is an investment manager with Walter Scott & Partners. Headquartered in Edinburgh, Scotland, the firm is the sub-advisor to the Clifford Scott International Fund, L.P. Sharon received her MBA from the University of Edinburgh in 1991 and has been an investment manager with Walter Scott & Partners since 1992. We appreciate her comments on the Euro and thank her for this contribution to our newsletter.

The Euro is a pure contrivance and as a mechanism for linking quite disparate economies is seriously flawed, perhaps fatally.

No Political Unity

A single currency cannot work without monetary, fiscal and ultimately political union. We are still far from this point in Europe, though the leading proponents of monetary union have made no bones about the fact that political union is the ultimate end game.

Eddie George, Governor of the Bank of England likened monetary convergence to limbo dancing. Once under the bar the dancer shoots up on the other side. Having artificially, if not spuriously, achieved the economic criteria for convergence there is the risk of explosion on the upside, which will leave the Euro unstable. We are starting to see this with high levels of inflation in countries like Ireland.

The European Central Bank's theoretical right to fine individual countries which step out of line, is in practice so politically unacceptable as to render it useless. In any case it will not ultimately solve the problems created by a one-size-fits-all monetary policy.

Danish Vote Significant

The 'No' vote in the Danish Referendum may have marked a turning point. For a small country so closely linked to the Euro bloc and whose currency followed the Deutschemark for many years, this was a significant outcome. Despite all attempts at 'Europeanisation' the Danes identification with the nation state remains strong. Being dictated to by unelected bureaucrats in Brussels, Strasbourg and Frankfurt is unacceptable. We have already gone far too far down this route.

With the Danes voting 'No', the Swedes are likely to follow, and the chances of Tony Blair winning a popular mandate to take the UK into the Euro become more distant. While the core Euro members would have liked to see the UK and the Scandinavians join, there is no indication that there is much appetite for wider enlargement of the European Union, a necessary precursor to Euro membership.

Euro is Weak

The Euro remains very weak. It sank to new lows below 85 cents before concerted central bank intervention. It has fallen around 26% from its introduction level. Where does it go from here?

There is, of course, a chance that the whole Euro arrangement breaks up. That, in our view, is possible but probably not imminent. There is a good deal of vested interest in keeping the show on the road for the time being.

The Germans carry all the emotional baggage associated with having fought (and lost) two world wars. At the political level it is felt that the best insurance policy against a similar fate befalling them in the 21st century is in integrating their economy with others in Europe, and that of France in particular. At the individual level people currently seem resigned to this fate, but may balk at being forced to hand over their Deutschemarks for Euros in 2002.

Central Banks Intervene

As to the level of the currency, there are a number of supportive factors. Central bank intervention is one. The USA in particular has signalled its dislike of a Euro in free fall. While the huge current account deficit is being financed by for-

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eign capital flows, U.S. companies are currently reporting profit shortfalls as a result of lower Euro earnings. A weak Euro means weakened U.S. competitiveness. Though interventions are just a drop in the ocean of global currency trades, they do at least demonstrate that the Euro trade is no longer a one way street.

Europeans Invest in U.S.

Capital flows from Europe into dollar assets have been abnormally high. Euroland cross border mergers and acquisitions (M&A) has been running at 7% of GDP up from 0.5% two years ago. 7% is over twice the level of GDP growth expected in Europe this year. This M&A activity has been predicated by a huge rise in corporate bond issuance, which has interestingly turned down quite sharply this year. This suggests that M&A activity will fall off quite sharply also.

Euroland purchases in the U.S. equity markets have risen sharply over the last two years. Part of this is due to a strategic reorientation of portfolios. With the advent of the Euro the opportunities to diversify within the Eurobloc were lost. Institutional investors therefore increased their allocations to foreign equities, particularly U.S. ones. This repositioning is probably now complete. Indeed, given the strong performance of the U.S. market in 1999, some of the gains may be repatriated.

U.S. Growth Rate Crucial

Much of what happens to the Euro will depend on what happens in the U.S. While U.S. growth, currently running in excess of 5%, may not slow sufficiently next year to converge with European growth, currently just over 3%, it will almost certain slow more rapidly. The risk of earnings disappointments is likely therefore to be higher. This means that as a destination for Euros, U.S. assets may become increasingly unattractive.

Europe is Improving

Also on the positive side, unemployment in Europe continues to fall and consumer confidence remains at a high level. Euro-zone interest rates are unlikely to rise much further and will probably peak around 5%. The Euro-zone budget position will be moving towards a surplus this year. This is allowing for a fiscal easing of $24 billion over 5 years in Germany and $16 billion over 3 years in France. The Netherlands, Spain, Italy and Belgium have signalled their intention to follow suit. This will feed into consumption and company earnings.

In addition, plans for pension reform are on the table which will allow individuals some discretion as to where their contributions are made. Assuming these contributions are invested in Euro denominated assets, that can only be good news for both the currency and the market.

Clifford Associates will continue to monitor the European markets and currency, not only for the Clifford-Scott International Fund, but also for the individual international stocks our clients own. Also, many U.S. companies have significant exposure both to the Euro, and the European consumer markets. Meanwhile, it's a great time to travel to Europe.

Bruce White